Agency Costs, Corporate Governance Mechanisms and Performance of Public Listed Family Firms in Malaysia

Haslindar Ibrahim* and Fazilah Abdul Samad**

We compare corporate governance and performance between family and non family ownership of public listed companies in Malaysia from 1999 through 2005 measured by Tobin's Q and ROA. We also examine the governance mechanisms as a tool in monitoring agency costs based on asset utilization ratio and expense ratio as proxy for agency costs. We find that on average firm value is lower in family firms than non family firms, while board size, independent director and duality have a significant impact on firm performance in family firms as compared to non family firms. We also find that governance mechanisms have significant impact on agency costs for both family and non family firms.

Field of Research: family ownership, agency costs, corporate governance, ownership structure

1. Introduction

Family-controlled firm or family ownership is the most common form of business organization in the world. A various stream of literature explains that family ownership is central in most countries. La Porta, Lopez-De-Silanes, and Shleifer, (1999) studied the 20 largest publicly traded companies in the richest 27 countries worldwide and found most companies are private and the ownership of listed firms is highly concentrated which highlighted family ownership as a significant corporation. The family-owned or controlled businesses account for over 80 percent of all firms in the U.S. Indeed, families are present in one third of the S&P 500 and hold nearly 18 percent of firms' equity stake (Anderson and Reeb, 2003).

Ownership structure has been widely debated since Berle and Means (1932). According to Jensen (2000), ownership structure is significant in determining firms' objectives, shareholders wealth and the disciplined of manager. Both managers and shareholders should have a single objective of maximizing firm value.

*A PhD candidate at the Faculty of Business and Accountancy, University of Malaya, 50603 Kuala Lumpur, Malaysia, email: haslindar@yahoo.com

**An associate professor at the Faculty of Business and Accountancy, University of Malaya, 50603 Kuala Lumpur, Malaysia, email: mfazilah@um.edu.my

However, managers have other interests that may not be in line with those of the shareholders' thus causes agency problems that eventually lead to poor firm performance. Fama and Jensen (1983) explained that separating control from management helps mitigate agency problems and facilitate specialization of management. Jensen and Meckling (1976) suggested that family-controlled businesses should be more efficient than professionally-run firms because the costs of monitoring are less in family firms as compared to non-family firms. Further, family relationships among owner-managers should also reduce agency costs since family members can monitor and disciple managers (Fama and Jensen, 1983; DeAngelo and DeAngelo, 1985).

In Malaysia, family ownership constitutes over 42 percent of the main board companies of the Bursa Malaysia (formerly known as the Kuala Lumpur Stock Exchange (KLSE)) from 1999 through 2005 yet studies examining the performance of family ownership are very limited specifically in the area of corporate governance and agency costs. Thus we intend to investigate the impact of corporate governance mechanisms such as board size, independent director and duality on performance, as a tool in mitigating an agency costs between family and non family firms in Malaysia.

Based on market capitalization, on average, family-controlled firms in Malaysia are smaller with average market capitalization of RM0.79 billion as compared to non family-owned firms at RM1.3 billion. While 60 percent of 122 family-owned firms in our sample hold more than 40 percent of the equity ownership and on average, firm value of family-owned firms is lower than non family as measured by Tobin's Q and ROA. Our results showed that on average, family firms experience lower agency costs as compared to non family firms based on the asset utilization ratio and expense ratio using agency cost proxies, and that board size, independent director and duality for family ownership has a strong significant influence on firm performance. This is consistent with the previous studies by Ang, Cole and Lin (2000), McKnight and Mira (2003), and Jensen and Meckling (1976).

2. Literature Review

2.1 Family Ownership in Malaysia

Family ownership is very significant in developing and building a country. According to Claessens, Djankov and Lang (2000) studies of the separation of ownership and control in nine East Asian corporations (Hong Kong, Indonesia, Japan, South Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand), Malaysia is the third highest concentration of control after Thailand and Indonesia. Family ownership in Malaysia increases from 57.7 percent to 67.2

percent as the cut off level of voting right increases from 10 percent to 20 percent.

Jasani (2002) found that Small and Medium Scale Enterprises (SME) are managed by the founder and anchored to the family in terms of funding and employment. Indeed, the firms are conducted by the founder with activities concentrate on trading, manufacturing and retailing. He found that 59 percent or majority of the businesses in Malaysia are still managed by the founder while 30 percent are run by the second generation where the majority are the founder's children. The founder reign is highlighted with 65 percent of them linked to the SME.

2.3 Corporate Governance and Firms Performance

Corporate governance mechanisms such as board size, independent director and duality have been found to influence firm performance hence affect family-controlled firms. Singh and Davidson III (2003) corroborated that the size and composition of the board may reflect its ability to be an efficient guide and that firm performance is increased by smaller boards (Yermack, 1996; Eisenberg, Sundgren, and Wells, 1998). This is further supported by numerous other studies which confirmed that large boards are not as effective as the small boards (Jensen and Meckling, 1976; Shaw, 1981; Olson, 1982; Gladstein, 1984; and Lipton and Lorssch, 1992).

Fama and Jensen (1983) explained that board outsiders could strengthen the firm value by lending experienced and monitoring services and supposed to be guardians of the shareholders' interests via monitoring while Coughlan and Schmidt (1985) and Hermalin and Weishbach (1991) support the argument that outside directors are more effective monitors and a critical disciplining device for managers. Klein, Shapiro, and Young (2005), Subrahmanyam, Rangan, and Rosenstein (1997), and Agrawal and Knoeber (1996) found that board independence is in fact negatively correlated with performance. Hermalin and Weishbach (1991) posited no significant relationship between performance and outsiders' proportion on the board of directors. However, Baysinger and Butler (1985), Lee, Rosenstein, Rangan, and Davidson (1992) and Byrd and Hickman (1992) explained a positive relationship between performance and outsiders' proportion.

Duality can be defined as a board structure control mechanism which is explained as the same person serving as both the chief executive officer (CEO) and chairman of the board. The Cadbury Committee assumed the practice as unnecessary because it potentially provides one person too much power over the decision making process (Cadbury, 1992). Previous studies analyzing the impact of duality on firm performance have been mixed. As such, Weir, Laing, and McKnight, (2002) found that duality showed no role as to enhancing firm performance in the U.K firms whereas in the U.S studied by Boyd (1994) found

that duality actually bring to better performance. McKnight and Mira (2003) found that duality had a moderately strong and negative impact on quality values. In other words, firms where duality did exist performed poorly with respect to those firms where CEO did not occupy both positions

2.4 Corporate Governance and Agency Costs

Agency costs occur from the misalignment of interests between the firm's managers and the firm's shareholders. This conflict of interest between manager and shareholders is caused by the physical presence of excess cash or cash equivalents (Jensen and Meckling, 1976). There are scarce studies on examining the relationship between agency costs and certain board structure and ownership characteristics.

The presence of a non-executive on the board is perceived as a governance mechanism that could help in monitoring the agency problem. Consequently, Berle and Means (1932) and Jensen (1993) opened to debate whether non-executive directors indeed promote shareholders interest. Some researchers explained that non-executive directors are more likely to align themselves with top management rather than the shareholder. This is due to top managers have a great influence over who is on the board (Hermalin and Weishbach, 1998) and because non management directors typically hold an unimportant portion of the firm's stock (Brickly and Coles, 1994; and Rhoades, Rechener, & Sundramurthy 2000). McKnight and Mira (2003) found that as the number of non-executive on the board increases, agency costs tends to decrease and this evidence supports that argument. The average number of additional directorships held by board members had a positive impact on firm performance (Dowen, 1995), whereas Klein (1998) acknowledged a weak relationship with performance. In addition, Florackis and Ozkan (2004) found that the smaller the board size, the higher the agency costs. Hence, previous study found that duality has no influence on agency costs (Florackis and Ozkan, 2004; McKnight and Mira, 2003).

3. Data and Methodology

A total of 474 companies were listed on the main board of the Bursa Malaysia as at 31 December 1999. All financial and unit trust companies were omitted from the study because of differences in regulatory requirements. In addition, the study excluded companies which fail to comply with any obligations under Practice Note such as Practice Note 4 (PN4)[a] and Practice Note 17 (PN17)[a] and also companies with incomplete data. As a result we selected 2030 observations for 290 companies across seven years from 1999 to 2005 as our sample. The data was taken from the annual reports and financial databases such as Worldscope, Datastream, and Perfect Analysis.

Based on previous studies, we classify family firms based on two criteria. The first criteria is that of the presence of family member on the board while the

second criteria is that family members must hold at least 20 percent of outstanding equity stake (Anderson and Reeb, 2003; La Porta, Lopez de Silanes Shleifer, and Vishny 1998; and Berle and Means, 1932). We used board size, independent director, and duality as governance mechanisms. Finally, we used firm size, firm risk and firm age as control variables.

The study used market measure (Tobin's Q) and accounting measure (ROA) as performance measurement since both performance measures have been widely used as proxies for firm performance (Haniffa and Hudaib, 2006; Anderson and Reeb, 2003; Rhoades, Rechner, and Sudramurthy, 2001; McConnell and Servaes, 1990)

The asset utilization ratio and the expense ratio are used as proxies for agency cost based on studies by Florackis & Ozkan, (2004), Singh and Davidson III (2003), Ang et al. (2000). The asset utilization ratio is measured by the ratio of annual sales to total asset. This ratio measures of how effectively the firm's management deploys it assets. Low asset utilization ratio indicates a high agency cost which means poor investment decision, insufficient efforts and purchase unproductive products. Besides, the expense ratio is scaled by operating expenses to annual sales of the company. This ratio measures of how effectively the firm's management control operating costs. High expense ratio indicates high agency costs.

We used univariate and pooled time-series, cross-sectional analysis in this study. Data for the univariate statistics is based on time-series averages for each firms and then averaging across firms. On the other hand, pooled time-series and cross-sectional data refers to the data consist of observations on the same cross-section variables over several time periods. In this analysis, fixed effect with cross section weight has been used for individual and period effect to correct cross-section heteroskedasticity problem.

Thus we develop the two following models in the study: Model 1 to analyze the relationship between corporate governance and performance for both family and non family ownership; Model 2 to analyze the relationship between corporate governance mechanisms and agency costs for both family and non family ownership. The operationalisation of the research variables are presented in Table 1.

Model 1

$$\text{Firm Value} = \alpha_0 + \beta_1 Risk + \beta_2 Age + \beta_3 Lnasset + \beta_4 Bsize + \beta_5 OutDir + \beta_6 Duality + \beta_7 Family * Risk + \beta_8 Family * Age + \beta_9 Family * Lnasset + \beta_{10} Family * Bsize + \beta_{11} Family * OutDir + \beta_{12} Family * Duality + \varepsilon$$

Model 2

$$\text{Agency Cost} = \alpha_0 + \beta_1 Risk + \beta_2 Age + \beta_3 Lnasset + \beta_4 Bsize + \beta_5 OutDir + \beta_6 Duality + \beta_7 Family * Risk + \beta_8 Family * Age + \beta_9 Family * Lnasset + \beta_{10} Family * Bsize + \beta_{11} Family * OutDir + \beta_{12} Family * Duality + \varepsilon$$

4. Results and Discussion

Table 2 presents the descriptive statistics for full and individual sample for family and non family ownership in Malaysia. Market measures as indicated by Tobin's q shows that non family ownership have greater valuations than family ownership, 1.061 versus 0.792 for non family and family ownership respectively and significant at 1 percent level. However, with respect to ROA, family ownership has insignificant lower value than non family. In addition, agency costs proxies as measured by the asset utilization ratio and expense ratio, on average, reveal that family ownership experience low agency costs. However, these mean differences for both agency costs proxies are not statistically significant.

For corporate governance structure, we found that board size for all samples, family and non family ownership is similar with an average of 8 persons on board. The independent director and duality shows a significant difference in mean between family and non family. Meanwhile, the frequency of the duality shows that only 6.5 percent of the samples have not separated the role of chairman and CEO on the board.

For all control variables such as firm risk, firm age, and firm size, the findings show that there is no difference between family and non family. The average firm age in the sample is nearly 30 years old, suggesting that Malaysian firms are well established since the (KLSE) stands on its own after separating from The Stock Exchange of Malaysia and Singapore (SEMS) in 1973. Based on total asset, family firms on average are smaller than non family firms at RM1.661 billion and RM2.137 billion respectively.

Table 3 presents the correlation matrix for the dependent and independent variables. Firm value as measured by Tobin's Q and ROA appear to bear a negative and positive relationship to board size and a positive and negative relationship to independent directors of the company. The results are consistent with a study on corporate governance and performance of Malaysian listed companies by Haniffa and Hudaib (2006). In addition, the presence of family ownership causes Tobin's q to have a significant negative relationship with duality but a significant positive relationship with independent directors. While a negative and not significant relationship is observed between family ownership and board size. This is consistent with studies by Mishra, Randoy and Jensen (2001) and Yermack (1996) on Norwegian and US family firms, respectively.

Table 1: Operationalisation of the Research Variables

Variables	Acronym	Measuring Variables
Ownership		
A. Family Firms	Family	The presence of family members on the BOD and the equity ownership of the family firms at least 20 percent. Takes a value of 1 if family firms and 0 otherwise
Performance Measurement		
A. Market Measures		
Tobin's Q	Q	The ratio of market capitalization plus total debt divided by total assets of the company
B. Accounting Measures		
Return on Asset	ROA	Net income divided by total assets of the company
Agency Costs		
A. Asset Utilization Ratio	AC1	Annual sales divided by total assets of the company
C. Expense Ratio	AC2	Operating expenses divided by the annual sales of the company
Board Structure		
A. Board Size	Bsize	Total number of directors on the board of the company
A. Independent Director	OutDir	The proportion of the independent directors to total number of directors on the board of the company.
B. Duality	Duality	The same person serving as both the chief executive officer and the chairman of the company. Takes a value of 1 if the same person serves as both the CEO and the chairman and 0 otherwise
Control Variables		
A. Firm Risk	Risk	Total debt divided by total assets of the company
B. Firm Age	Age	The number of years since the firm's inception
C. Firm Size	Lnasset	The natural log of total assets of the company

Table 2: Descriptive Statistics of Family Ownership and Non Family Ownership in Malaysia

Variables	Full Sample (N = 290)		Family (N = 122)	Non Family (N = 168)	t-statistics of Differences
	Mean	Std. Dev	Mean	Mean	
Performance Measures:					
Tobin's Q (Market Measures)	0.948	0.991	0.792	1.061	**-2.623***
Return on Asset (ROA) (Accounting Measures)	0.032	0.249	0.025	0.036	-0.364
Proxies for Agency Costs:					
Asset Utilization Ratio (AC1)	0.703	2.482	0.558	0.089	-0.850
Expense Ratio (AC2)	0.317	0.598	0.312	0.320	-0.114
Board Structure:					
Board Size	7.88	1.875	7.916	7.855	0.270
Independent Director	0.385	0.088	0.361	0.403	**-4.312***
Duality (%) – frequencies	93.5 (0)	6.5 (1)	13.1	1.8	**4.041***
Control Variables:					
Firm Risk	0.260	0.255	0.257	0.262	-0.173
Firm Age (years)	29.617	17.798	29.43	29.76	-0.155
Firm Size (total asset) ('000)	1,936,356.6	4,517,151.2	1,660,694.0	2,136,540.1	-0.885
Market Capitalization ('000)	1,100,952.6	3,189,398.3	788,269.8	1,328,019.9	-1.425

* Significant at 0.01 level

Table 3: Correlation Matrix

	Q	ROA	AC1	AC2	RISK	LNASSET	AGE	BSIZE	OUTDIR	DUALITY	FAMILY
Q	1										
ROA	.029	1									
AC1	.021	.009	1								
AC2	-.020	**.130***	-.060	1							
RISK	**.446****	**-.143***	.003	.086	1						
LNASSET	**-.281****	-.039	.016	-.081	-.021	1					
AGE	.112	-.051	-.100	.091	.058	-.019	1				
BSIZE	-.064	.038	.042	-.091	**-.145***	**.378****	**-.150***	1			
OUTDIR	.007	-.012	-.045	.086	.100	-.019	**.215****	**-.400****	1		
DUALITY	.004	-.027	-.015	.019	.038	.108	-.005	.003	-.003	1	
FAMILY	**-.134***	-.021	-.050	-.007	-.010	-.009	-.009	.016	**-.235****	**.261****	1

** significant at 0.01 level (2-tailed).
* significant at the 0.05 level (2-tailed).

4.1 Corporate Governance Mechanisms and Firm Performance

Next we analyzed the relationship between corporate governance mechanisms and performance of family and non family ownership in Malaysia using Tobin's Q and ROA as performance measures. With regard to board size, family ownership has a significantly negative impact on firm value as measured by Tobin's Q but insignificantly negative impact based on ROA. The result indicates that firms with smaller board have higher firm value and this is consistent with Haniffa and Hudaib (2006), Singh and Davidson III (2003), Mishra et al. (2001), Eisenberg et al. (1998) and Yermack (1996). However, board size is insignificantly negative (positive) relation to non family ownership based on Tobin's Q (ROA).

The coefficient for independent director of family ownership is negative for both measures but statistically significant based on ROA. It suggests that firms with lower board independence have higher firm value. The results support the findings of Klein et al. (2005), Mishra et al. (2001), Subrahmanyam et al. (1997), and Agrawal and Knoeber (1996). However, for non family ownership, the coefficient of independent director is positive but insignificant for Tobin's Q (Haniffa and Hudaib, 2006; Weir et al., 2002; Hermalin and Weisbach, 1991). Furthermore, by using ROA, the independent director of non family firms is positive and statistically significant at 5 percent level.

The previous findings on the impact of duality on firm performance have been mixed. The duality variable of family ownership is found to be negative and statistically positive in both performance measures. The results support the findings of McKnight and Mira (2003) and Haniffa and Hudaib (2006). Conversely, the duality of non family ownership is found to be insignificant and positive based on both Tobin's Q and ROA (Boyd, 1994).This results suggest that separating the duality role (CEO and Chairman) may be beneficial to shareholders.

In all regression models, firm risk of family and non family ownership has a significant impact on firm performance. The coefficient of firm risk for family firms is positive and significant but significant and negative for non family firms, while firm age is negatively and significantly related to firm performance as measured by Tobin'q in both family and non-family firms. This is consistent with McConaughy, Walker, Henderson, and Mishra (1998). Firm size as measured by Tobin's Q is negative and significant for both family and non family ownership suggesting that smaller firms have higher q values (Mishra et al., 2001; McKnight and Mira, 2003).

Table 4: Corporate Governance and Performance of Family and Non Family Ownership in Malaysia

Variables	Tobin's Q		ROA	
	Family (N=122)	Non Family (N=168)	Family (N=122)	Non Family (N=168)
Intercept	4.456 (23.928)***		0.237 (3.842)***	
Board Structure:				
Board Size	-0.014 (-4.224)***	-0.007 (-1.563)	-0.001 (-1.124)	0.001 (0.814)
Independent Director	-0.017 (-0.390)	0.087 (1.416)	-0.041 (-4.058)***	0.052 (2.324)**
Duality	-0.047 (-1.996)**	0.049 (0.716)	-0.024 (-2.563)**	0.051 (1.881)*
Control Variables:				
Firm Risk	0.676 (19.081)***	0.602 (17.817)***	-0.123 (-12.969)***	-0.185 (-12.522)***
Firm Age (years)	-0.016 (-10.262)***	-0.022 (-8.924)***	0.000 (0.013)	-0.003 (-4.101)***
Firm Size (lnasset)	-0.143 (-11.531)***	-0.282 (-13.432) ***	-0.001 (-0.281)	-0.014 (-1.724)*
Observation	2030		2030	
R-Squared	0.883		0.741	
Adjusted R-Squared	0.862		0.696	
F-Value	43.130 (p = 0.00)		16.42442(p = 0.00)	

*** Significant at the 1% level. ** Significant at the 5% level. * Significant at the 10% level.
t-statistics are in parentheses

4.2 Corporate Governance Mechanisms and Agency Costs

Table 5 presents the findings of the relationship between corporate governance and agency costs. The coefficient of board size is positive and statistically significant for both family and non family ownership as measured by the asset utilization ratio. The results indicate that firms with larger board size are more efficient in their asset utilization ratio. High asset utilization ratio indicates low agency costs. This is inconsistent with Florackis and Ozkan (2004).

Nevertheless, independent director is negatively and significantly related to family ownership. This indicates that as the number of outside or independent director increases, agency cost tends to increase in family ownership. This argument is supported by Ang et al. (2002) and the theory of Jensen and Meckling (1976) where family members are said to have less monitoring role that leads to increase in agency costs. However, asset utilization ratio is positively and significantly related to non family ownership. This result shows that as the number of independent director increases, the agency costs decrease. This finding is parallel with McKnight and Mira (2003) which suggested that independent directors may be beneficial to firm value given their knowledge and skills.

With respect to duality, there is a significantly positive relationship between family ownership and asset utilization ratio, indicating that when the position of CEO and chairman held by one person, agency costs tend to decrease. However, for non family ownership, the results show that agency costs as measured by expense ratio tend to increase when the firms implement the role of duality on the board. The results support the Cadbury Committee's view that duality role might give one person too much power in making the decision. The duality is not found to be significant as measured by expense ratio and asset utilization ratio for both family and non family firms, which support the arguments by Florackis and Ozkan (2004) and McKnight and Mira (2003) that duality has no influence on agency costs.

For control variables, firm size is significantly negatively related to expense ratio for both family and non family firms, indicating that smaller firms experience low agency costs. Furthermore, coefficients of firm age for family and non family ownership are found to be significantly positively related to agency cost as measured by asset utilization ratio. This indicates that as companies get older, this might mitigate agency costs since older firms are likely to be more efficient that younger firms due to the effect of learning curve and survival bias (Ang et al., 2000).

Table 5: Agency Cost and Corporate Governance of Family and Non Family Ownership in Malaysia

Variables	Asset Utilization Ratio (AC1)		Expense Ratio (AC2)	
	Family (N=122)	Non Family (N=168)	Family (N=122)	Non Family (N=168)
Intercept	0.350 (2.279)**		1.397 (9.203)***	
Board Structure:				
Board Size	0.005 (2.546)**	0.025 (4.052)***	0.004 (1.011)	0.002 (1.224)
Independent Director	-0.043 (-1.774)*	0.510 (5.294)***	0.045 (0.680)	0.0157 (0.575)
Duality	0.020 (2.044)**	-0.058 (-0.682)	-0.067 (-1.025)	0.058 (2.079)**
Control Variables:				
Firm Risk	-0.074 (-4.432)***	-0.109 (-2.381)**	0.130 (2.362)**	-0.008 (-0.478)
Firm Age (years)	0.014 (15.227)***	0.032 (10.058)***	0.016 (8.022)***	0.019 (17.829)***
Firm Size (lnasset)	-0.103 (-15.292)***	-0.001 (-0.030)	-0.102 (-4.023)***	-0.137 (-13.975)***
Observation	2030		2030	
R-Squared	0.963		0.712	
Adjusted R-Squared	0.956629		0.662	
F-Value	149.683 (p = 0.00)		14.224 (p = 0.00)	

*** Significant at the 1% level. ** Significant at the 5% level. * Significant at the 10% level.
t-statistics are in parentheses

5. Conclusion

Our main objective in this study is to investigate the relationship between corporate governance and agency costs between family and non family ownership. We found that on average, family ownerships have lower agency costs as compared to non family ownership but on a minus side, they have lower firm value. In addition, family ownership can further mitigate agency problems by retaining a small number of directors on board, minimizing outside directors, and adopting the role of duality. For non family ownership, instead of having a smaller board, the number of independent directors and duality role should be increased and separated respectively towards reducing agency costs. Our study further confirmed Malaysian firms especially family ownership are sensitive towards agency costs and corporate governance mechanisms.

End Notes

a. PN4 and PN17 are the criteria and obligations pursuant to paragraph 8.14 and 8.14c respectively of the listing requirements in the Bursa Malaysia. Both PN4 and PN17 occur when the firms having financial difficulties. PN4 is further amended to PN17 with effect on 3 January 2005.

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